Target date funds and the new active management

BlackRock®

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Demographics, global economics and financial markets have changed in the 27 years since BlackRock pioneered the target date fund. It should be no surprise that active management has changed as well.

Philip Green
Managing Director, Head of Global Tactical Asset Allocation

Phil Green, who manages LifePath® Dynamic, and his Global Tactical Asset Allocation team are at the leading edge of what he calls "the new active." He talked to us about how his team seeks alpha and its potential role in enhancing target date fund returns.

LifePath offers a variety of implementation options, with the same strategic glidepath. Can you help us understand how that works?
The strategic glidepath is based on human capital and spending research, lifecycle investment models, BlackRock's market expectations and robust optimization algorithms. This valuable intellectual property is the foundation for each LifePath fund as well as customized target date funds. These funds are invested mainly in U.S. and global stocks early on, shifting to more conservative investments, such as bonds, as investors get closer to retirement. LifePath Index seeks to capture the strategic glidepath as efficiently as possible. It also establishes the strategic benchmark LifePath Dynamic aims to outperform. LifePath Dynamic is for someone interested in active management and is looking for additional outperformance. We'll get into how in a minute, but that's how we define success: have higher returns, and better risk-adjusted returns, than LifePath Index.

How do you try to achieve that? What's in the toolbox?
We use a mix of traditional beta exposures through inexpensive index funds, true alpha strategies sourced from BlackRock active managers, and smart beta and factor strategies sourced from BlackRock's factors team. What differentiates LifePath Dynamic is our proprietary construction process. We allocate between them based on what we believe will maximize the probability of success at a given time.

We can also move plus or minus 10% around the equity weighting at any point on the strategic glidepath. This allows for greater flexibility, while respecting the longer term strategic objective of LifePath. Our approach to asset allocation is opportunistic, meaning we will only tilt the portfolio if we think there is a good chance we will make money. For example, we might modestly tilt the portfolio to equities or bonds or a specific country or region if our analysis determines they are attractive investments over the next 3-12 months.

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Let's talk about active management. How have target date funds typically incorporated active management?
Most target date funds anchor to their glidepath weight. So if the glidepath has 40% of its equity weight in large cap U.S. stocks, for example, then the target date fund will allocate 40% of its assets to active U.S. large cap funds. The same process happens for U.S. bonds, international equities and the other components of the glidepath. The result is a portfolio heavily weighted towards active strategies that tend to be the asset classes that are the hardest to generate alpha. There is a better approach as we will discuss.

What's different about the new active management approach for LifePath Dynamic?
When we say "new," we mean three key insights. The first is alpha-beta separation, which means searching for alpha strategies independent of the asset class weights in the glidepath. The second is differentiating between true alpha and factor exposures, and having a diversified set of active risk exposures at the portfolio level. The third is employing a proprietary process for active risk budgeting.

Let's start with the first. What is alpha-beta separation?
The first aspect of alpha-beta separation is that we look for alpha opportunities globally, not just in the asset classes within the glidepath. So let's say we've identified an attractive alpha opportunity in foreign bonds. There is no foreign bond allocation in the glidepath, but we're able to buy it as an alpha opportunity separate from the beta in glidepath weights.

Another example is allocating capital to active asset class strategies at different weights than the glidepath. For example, let's say the small cap weight in the glidepath is 2%. But we have identified a very attractive true alpha small cap strategy at BlackRock and we've allocated 10% of the capital. What do we do about the extra 8% exposure? Do we just leave it in the portfolio? The answer is a definite, "No." What we will do is hedge the extra 8% of small cap exposure with Russell 2000 futures to get the small cap exposure back to 2% and isolate the alpha exposure. What's important to understand is that we aren't allocating 10% of the capital because we have a view on small cap, we're doing it because we have a view on that manager's skill.

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Is the hedging strategy also intended to deliver return?
No. It's just to hedge away the beta. All we want is the alpha.

What's the process for the second key insight, which is diversifying factor exposure on a portfolio level?
We avoid concentrated factor exposures by making sure we use true alpha strategies, meaning they don't contain a lot of factor risk. Many active strategies take a lot of concentrated factor risks. Their managers begin by screening thousands of stocks for certain characteristics, like success, to whittle down the universe to maybe fifty or so stocks. Whether success is defined as price success or earnings success or something else, the fifty stocks that pass the screen will correlate to the momentum factor. We only want to invest in true alpha strategies that we believe are independent of factor or market cycles and we don't want to pay active fees for returns driven by factor exposure.

This rigorous approach to understanding *how* an underlying manager generates excess return, allows for less factor exposure overlap when bringing together a group of active strategies.

Now for the third insight. What do you mean by risk budgeting?
Risk budgeting is how we determine our allocations to beta, factor and pure alpha strategies to maximize our probability of success in creating a more consistent overall active return stream. There are a number of elements that come into play, including our alpha targets, the confidence we have in the pure alpha strategies we've identified and our return and risk assumptions. Once we determine how much risk we want to take through pure alpha strategies, we decide how we want to "budget" that risk.

We ask: how confident are we in our pure alpha security selection strategies? How confident are we in our pure alpha asset allocation strategies? What are our risk and return assumptions for each? How well are the strategies expected to diversify each other across different market environments? So we'll spend the risk budget across the combination of strategies we believe will help us meet our risk-adjusted return target.

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Can you talk about how you identify strategies you may want to allocate to?
Let's use BlackRock's Systematic Active Equity (SAE) team as an example. They are very in tune to factor exposures. They know that if they are going to be successful, they need to beat their benchmark in a way that a normal person like you and I can't do through smart beta factor funds. They know they need to build a process and build a portfolio where their outperformance is uncorrelated with factor performance.

For example, the SAE team doesn't use screens in the traditional sense of twenty years ago. They use what they call signals. They are constantly searching the universe of data for signals that others haven't seen to help them get to an edge on the market. They ask themselves, "Is the signal just momentum or value or some other smart beta factor exposure in disguise? Can the signal lead to true alpha?" Those managers who employ a rigorous and cutting-edge investment process and who can generate true alpha are the ones we want to bring into LifePath Dynamic.

Do you have time horizons in mind when you make investment decisions?
The strategic glidepath captures BlackRock's long-term capital expectations. When we make active asset allocation decisions, our time frame is shorter, typically between three months and one year. When we invest in pure alpha security selection strategies and diversified factor funds, our horizon is a bit longer, two or three years. For the most part, we haven't found that skill in security selection changes much in a year or two. Still, things change. A manager or a team may leave, or the rest of the market may catch on and their edge becomes commoditized. Or we simply find an opportunity we like better.

Can you bring it all together for us? Who should consider LifePath Dynamic?
LifePath Dynamic is for someone who believes in active management and is interested in a target date fund that is going to pursue tactical opportunities to provide a different risk return profile than the macro factors in LifePath Index.

Our process is deliberate. We believe in making opportunistic and diversified investment decisions to achieve our return target, and that we take action only when we believe we have a high probability of success. I believe that the more familiar someone is with our process and the new active management, the more convinced they will be that we can achieve our objective.

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Contact your BlackRock relationship manager to learn more about our target date fund strategies.

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Want to know more?

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The LifePath® Funds may be offered as mutual funds. You should consider the investment objectives, risks, charges and expenses of each fund carefully before investing. The prospectuses and, if available, the summary prospectuses contain this and other information about the funds, and are available, along with information on other BlackRock funds, by calling 800-882-0052 or from your financial professional. The prospectuses and, if available, the summary prospectuses should be read carefully before investing.

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